

COMMENTARY ON “TOWARDS A MARKET IN UNMATURED TORT CLAIMS”: A LONG WAY YET TO GO

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PROFESSOR Cooter has written an interesting and provocative paper but it constitutes an introduction to its subject, not a full treatment of it. The paper makes two claims: First, tort law forces potential victims to purchase excessive insurance against accidents. People will voluntarily insure against only those accidents that will increase their marginal utility for money, but the law requires full compensation for all tortious injuries. When the potential injurer is a seller, who reflects anticipated tort liabilities in prices, the law thus requires potential victim buyers to purchase excessive insurance. This claim is correct but not original. The first formal proof appeared in a 1977 article by Cook and Graham¹ and has since been reproved by several scholars, including Sam Rea² and, most recently, me.³ It is unnecessary to discuss the point again here. Cooter's second claim is that the law should be changed to permit a market for unmatured tort claims (UTCs) to form.⁴ My comment analyzes this second claim.

I will make three points. First, if potential victims can price risks perfectly, then allowing a UTC market, supposing one would arise if there were no legal impediment, would increase welfare, though not significantly. It is questionable, however, whether the state would permit the bargains that would yield this increase. Second, if potential victims are imperfectly informed, conventional wisdom holds that no UTC market should be permitted; if the law did not now erect barriers to the formation of such mar-

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¹ Cook and Graham, *The Demand for Insurance and Protection: The Case of Irreplaceable Commodities*, 91 Q.J. Econ. 143 (1977).

² Rea, *Nonpecuniary Loss and Breach of Contract*, 11 J. Legal Stud. 35 (1982).

³ Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 Yale L.J. 353 (1988).

⁴ The virtues that Cooter claims for such a market, that it will permit the better achievement of the law's compensation and deterrence goals, were anticipated in Friedman, *What Is 'Fair Compensation' for Death or Injury?*, 2 Int. Rev. Law & Econ. 81 (1982), which makes many of the same points as the paper here, particularly the claim that a market for unmatured tort claims would help avoid the difficulty that compensation would otherwise be excessive from an ex ante point of view. The advantages of permitting matured tort claims to be sold were recently set out in Shukatis, *A Market in Personal Injury Tort Claims*, 16 J. Legal Stud. 329 (1987).

kets, it likely would regulate them out of existence were they to form naturally. Third, putting these objections aside, UTC markets may not form naturally, and likely would generate undesirable equilibria if they did form. Taking the three objections together, I conclude that the case for a UTC market has yet to be made.

I. THE PERFECT INFORMATION CASE

A. *The Bargaining Situation*

When potential injurers and potential victims bargain *ex ante*, there is no need for law reform because a market for UTCs already exists. Consider the sale of a product. If the seller proposes reducing the price in return for a disclaimer, the seller is seeking to purchase the consumer's unmatured claim for damages for breach of warranty; should the consumer agree to the proposal, she has sold her UTC. If consumers in this market are well informed about the probabilities and costs of accidents, the first best solution respecting compensation and deterrence will be reached. Respecting deterrence, the consumer will purchase all marginal reductions in the risk of harm that cost the firm less than the consumer is willing to pay for safety; respecting compensation, if first-party insurance is cheaper than third-party insurance, the consumer will take a disclaimer regarding the remaining risk, and use the price saving to buy market insurance.⁵ This analysis just rehearses the well-known result that when information is perfect and the parties can bargain, a no liability rule is efficient. This result can be rephrased: the existence of perfectly competitive product and labor markets implies the existence of a thriving and efficient trade in UTCs. Professor Cooter thus gives us a new way to put an old result.

B. *The Nonbargaining Situation*

When potential injurers and victims do not bargain, deterrence and compensation today are achieved through tort suits. The law does not require excessive insurance in this case. Potential victims can buy only the first-party insurance, against pecuniary harm, that they prefer and will then sue for total compensation when injured, thereby facing firms with the full social costs of their actions. The question is what is to be gained in the nonbargaining case by permitting a set of third parties—called here “the buyers”—to purchase potential tort claims from nascent victims. In the way of deterrence, nothing: without the buyers, the victims would sue for full compensation; with the buyers, the buyers will sue for full compensation. In either case, the injurers face the same liability and will respond to it in the same

⁵ These points are demonstrated more fully in Schwartz, *supra* note 3, at 361-68.

way.⁶ There does seem something to be gained on the selling side. Before Cooter's suggested reform, potential victims own nothing of value regarding a possible accident; were the reform enacted, they would own a UTC that can be turned into cash. Removing the legal barrier to the sale of tort claims thus creates gains for potential victims that are not offset by losses elsewhere. Cooter's proposed reform therefore is efficient. This is not the case for the reform that Cooter makes, but it is the best case I see.

The case nevertheless is problematic. To see why, ask why a potential victim would sell a UTC rather than await events. If potential victims are more risk averse than the buyers, as seems likely, there are gains from trade. The second major reason for a sale is troublesome. Suppose that potential victims have higher discount rates than the buyers, because the victims are natural persons while the buyers likely are firms. Then there also are gains from trade but it is questionable whether society prefers trade. The best case for social security, recall, is that people have irrationally high discount rates and so will save too little when left on their own.⁷ So here, potential victims may have irrationally high discount rates and thus be willing to sell UTCs for too little; if so, the law's compensation goal would be vitiated. This difficulty could especially infect what may be an important submarket, the sale of UTCs for toxic torts. People frequently know that they have been exposed to toxic substances but realize also that any resultant disease likely will manifest itself after a long latency period.⁸ The knowledge that one is a potential victim would incline one to sell a UTC, but because of the long latency period, and low discount rates, the sellers would demand too little.

To summarize, if information respecting risks is perfect and potential injurers and victims bargain *ex ante*, a UTC market would be in place and work perfectly, so there would be no need for Cooter's reform. If no *ex ante* bargains exist, there would be a case for the reform but the case apparently

⁶ Third-party purchasers of claims may be able to litigate them more cheaply than seller victims because of economies of scale or the efficiencies of specialization. When either comparative advantage exists, the deterrence goal apparently would be better served by allowing claims to be sold; more valid claims would then be brought against injurers than individual victims currently bring. This conclusion does not imply that a market for UTCs should exist. Economies of scale today are realized through class actions, and any benefits of specialization could be obtained by permitting the sale only of matured claims. See Shukatis, *supra* note 4, at 334-41.

⁷ See J. Pechman, H. Aaron & M. Taussig, *Social Security: Perspectives for Reform* 60-65 (1968).

⁸ Many toxic exposures that eventuate in disease have long latency periods. For example, exposure to asbestos, tremolite, anthophyllite, and actinolite may result in diseases the symptoms of which will not generally manifest themselves for twenty or more years after the initial exposure. See OSHA Occupational Safety and Health Standards, 29 C.F.R. § 1910.1001, App. G (1988).

does not rest on better achieving the tort law goals of compensation and deterrence; rather, it rests on giving potential victims a new asset—a UTC—at zero cost. There is reason to believe, however, that the victims would charge inappropriately low prices when selling this asset, which would be inconsistent with the law's compensation goal.

II. THE IMPERFECT INFORMATION CASE

Consumers and firms and workers and firms today can bargain *ex ante* over potential tort claims but the law prohibits such bargains, on the ground that consumers and workers are imperfectly informed about risks. The regnant legal doctrine is strict liability in tort, which bans exculpatory clauses. Cooter claims that the primary field of operation for his reform is the bargain between the potential injurer and potential victim; and he assumes that this bargain cannot be conducted today because the law prevents trading in UTCs. This assumption is true in the bargaining case but not because archaic rules prohibit the sale of causes of action in tort. When courts believe that potential victims are informed, as when they are large corporations, courts permit the victims to sell their UTCs, by agreeing to disclaimers. When courts believe that victims are uninformed, these trades are prohibited. Thus Cooter's advocacy of a UTC market reduces to the claim that the strict liability in tort doctrine should be repealed. To sustain this claim, Cooter must show that consumers and workers in fact are informed, or can conveniently be informed.⁹ If he cannot make either showing, no state will permit a "UTC market" in the bargaining case. Nor will states create a UTC market in the nonbargaining case; the potential victim sellers there seem no better informed than are today's consumers and workers, and the state will no more permit them to sell UTCs than it now permits consumers and workers to sell them.

Cooter tries to meet the imperfect information objection, but his efforts need more development than the paper gives them. He initially argues that if a potential victim undervalues his claim and so would be willing to sell it to the potential injurer for too little, the buyers—insurance companies and law firms—will enter to bid the claim up. This argument is incomplete. To

⁹ I attempt to make both showings in Schwartz, *supra* note 3, at 378-84 (arguing that the evidence fails to support claims that consumers misperceive risks in such fashion as would disadvantage them and that consumer errors cannot be corrected) and so am sympathetic to Cooter's thesis. For an earlier effort along the same lines see Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 Va. L. Rev. 1387 (1983) (arguing that the existence of imperfect information does not cause sellers to degrade the quality of product warranties). Cooter should either explicitly adopt my views or, what would be better, improve on them; I haven't convinced as many people as I would have liked.

see why, suppose that there are no third-party buyers but N sellers exist in the relevant product market, each selling a homogeneous good for \$100, and that consumers are perfectly informed in the two senses that they can acquire information about market opportunities at zero cost and can price risks accurately. Seller #8 offers to reduce the product's price by \$8 in return for a disclaimer—that is, offers to buy the UTC for \$8. The claim actually is worth \$12, which the buyer knows. Seller #5, say, will attempt to take the sale away from seller #8 by offering a \$9 price reduction and a disclaimer; but then another seller has an incentive to offer \$10. The only equilibrium of this process entails all claims selling at their real values—\$12 in this example. Hence, if consumer sellers of UTCs are perfectly informed, there is no need to create a set of third-party buyers to protect them.

Consumers are thought not to be perfectly informed for two reasons: First, the costs of acquiring information about market opportunities are positive. Consequently, consumer buyers—the UTC sellers here—engage in too little comparison shopping; they will too seldom leave seller #8 to learn what other sellers are offering. Second, consumer buyers misvalue risks—that is, potential tort claims. Cooter apparently accepts the former objection; he says that high transaction costs block comparison shopping for claims whose contingencies rarely mature. If this objection holds, however, the entry of law firms and insurance companies will not cure the problem that potential victims will sell their UTCs for too little; the potential victims would not shop extensively across potential buyers and so would take insufficient advantage of the entry of new firms such as insurance companies. The second objection, that potential victims misvalue risks, applies equally to persons who do not bargain with firms as to persons who do. In sum, the addition of a set of third-party buyers cannot itself cure the information problems of insufficient search and risk misvaluation, if these problems actually exist.

Cooter's second attempt to meet the information difficulty is to require that the law not enforce the sale of a UTC unless the sale is the result of a bargain.¹⁰ This is similar to the rule in some states that the law will not enforce a disclaimer unless the parties bargain over it.¹¹ Bargaining ensures that the buyer knows the disclaimer exists, but the bargain requirement is

¹⁰ Cooter also suggests the additional requirement that a UTC sale should not be enforced unless the potential victim has adequate first party insurance at the time an injury occurs. I made the similar suggestion that the enforceability of a disclaimer—a UTC sale in a bargaining context—should be conditioned on the possession of first-party insurance. The proposal and its problems are discussed in Schwartz, *supra* note 3, at 407-08.

¹¹ See, e.g., *Dobias v. Western Farmers Ass'n*, 6 Wash. App. 194, 491 P. 2d 1346 (Ct. App. 1971) ("Disclaimers of warranty are disfavored in the law and ineffectual unless explicitly negotiated . . . and set forth with particularity. . . .").

not responsive to the problem Cooter uses it to solve. The bargaining requirement does not compel the seller to disclose information about risks; hence, buyers will make as many mistakes about risks after the requirement is imposed as before. This is why the bargaining requirement permits "bargained for" disclaimers only if the buyer is a business; states with the requirement continue to prohibit disclaimers of consumers' personal injury losses. Bargain requirements, in short, respond to the problem that people may be unfairly surprised by exculpatory clauses that are set out in fine print but do not respond to other aspects of the imperfect information concern.

If one accepts the common view that imperfect information problems are such that individuals should not be allowed to bargain over clauses allocating personal injury risks, there is no case for Cooter's reform. It would permit the very people whom current law prevents from bargaining over risks to sell their rights to compensation to potential injurers. Thus it would be better for Cooter first to show that the strict liability in tort doctrine is misconceived. Once this is established, the case for a broader UTC market than now exists follows naturally. One cannot both accept current substantive tort law and advocate the creation of a UTC market.

III. THE NATURE OF A UTC MARKET

When the parties do not bargain, one may ask whether a UTC market will form naturally and what such a market would look like. These will be important questions if Cooter can meet the discount rate and imperfect information objections made above. The principal impediment to the formation of a market for UTCs is adverse selection. To see the difficulty, consider a potential victim who offers an insurance company buyer the victim's right to recover for nonpecuniary harm. This claim will be worth little if the victim is a stoical person who, in the eyes of a jury, would appear impervious to pain; but the claim would be worth a lot if the victim suffers agonies from hangnails. Potential victims thus have an incentive to overstate their capacity to suffer in order to make their UTCs appear more valuable. Because information relating to the future value of a consumer's nonpecuniary claim is not verifiable—it is known only to the consumer—the UTC market is a classic "lemons market," in which the most likely initial equilibrium is for potential victim UTC sellers to pool¹² at a low price. When victim sellers vary noticeably in their capacity to suffer, the maximizing strategy for buy-

¹² When buyers in a market are of different types, a "pooling" equilibrium exists if the sellers cannot distinguish buyers by type and so must charge all buyers the same price for the product or service. A "separating" equilibrium exists when sellers can distinguish among buyers; then each buyer will be charged a price that reflects the costs of serving him. In the example in text, it is the victim sellers whom buyers may be unable to distinguish and so in a pooling equilibrium each buyer must pay the same price for every UTC.

ers of UTCs would be to suppose that the average capacity is low and so offer only low prices. Then either of two outcomes are likely to occur, both of which would be unsatisfactory. First, those victims who actually have valuable UTCs will defect from the equilibrium and not sell; instead, they will sue if they are injured. In this event, the UTC market will unravel—there will be too few big sufferers remaining in it to make serving the market worthwhile to buyers—and Cooter's reform will be for nought. Analyses of insurance markets suggest that this is a possible outcome. The purchaser of a UTC claim, as Cooter recognizes, is in effect offering insurance against the claim to the potential victim seller. Insurance companies now do not offer insurance against nonpecuniary losses partly, it is thought, because they cannot distinguish among potential insureds on the ground of capacity to suffer and so would be plagued by adverse selection.¹³ It is unlikely that an insurance company in its capacity as a tort-claim buyer would offer insurance that it now refuses to offer in its capacity as an insurance seller. The second likely outcome is that a UTC market will exist and victims will sell UTCs on it for low prices, to compensate the buyers for the risk that some of the sellers are "lemons." This outcome is inconsistent with the law's compensation goal.

Cooter acknowledges the problem of adverse selection as "an obstacle" but not a reason for the law to close markets by fiat. This response is correct but insufficient. If a UTC market is unlikely to form, why advocate one? If the likely equilibrium in this market, were it to form, would be for potential victims to sell valuable claims at fire sale prices, why desire one?¹⁴

IV. CONCLUSION

The part of this paper that advocates a market for UTCs is interesting but not fully worked out. The principal difficulty is that the paper insufficiently recognizes that when potential injurers and victims can bargain before accidents happen, UTC markets will exist naturally. No such markets are seen in the consumer and employee case because the law prohibits them on the ground of imperfect information. Consequently, the necessary first step to

¹³ See Schwartz, *supra* note 3, at 364-65.

¹⁴ The information problems considered here perhaps could be cured by some form of intermediation. Suppose that a labor union bought its workers' UTCs. If the union was better informed than its workers about the value of these claims and behaved as a fiduciary toward the workers in the sense that it paid workers each claim's true value, then that the workers are imperfectly informed about the value of their UTCs would not matter. And if the workers behaved as fiduciaries toward their union in the sense that the workers did not overstate the value of their claims, the adverse selection problem could vanish as well. The assumptions on which these happy results rest seem heroic, however. Also, most potential victims are not represented by unions; no other possibly trusting and trustworthy UTC purchaser is apparent.

be taken in making a case for UTC markets is to defeat or otherwise cope with the imperfect information objection. The second step, if the first can be taken, is to characterize the likely equilibrium in the UTC market and show that it advances the goals of tort law. The paper takes neither step, and so is an interesting and provocative introduction to an important subject, not a full treatment of it.